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SUBJECT: EDRC ANNUAL REVIEW OF SWITZERLAND

REF: A. USOECD 2292; B. OECD DOCUMENT EDR(75)2

1. SUMMARY: MAIN CONCLUSION OF EDRC REVIEW JANUARY 30 WAS THAT SWISS MAY BE TOO COMPLACENT ABOUT ACCEPTING NEGATIVE REAL GNP GROWTH RATE IN 1975 (-1.2 PERCENT) AS PRICE FOR CONTROLLING INFLATION AND BRINGING ABOUT STRUCTURAL ADJUSTMENTS IN ECONOMY. SECRETARIAT AND EDRC FELT THAT MODEST STIMULATION OF ECONOMY WOULD BE DESIRABLE TO COUNTER DECLINING INVESTMENT AND RISING (THOUGH STILL SMALL) LEVEL OF UNEMPLOYMENT. SWISS DELEGATION, LED BY PROFESSOR L'HUILLIER OF UNIVERSITY OF GENEVA, THOUGHT SUCH ACTION WAS PREMATURE, BUT ASSURED EDRC THAT APPROPRIATE MEASURES WOULD QUICKLY BE TAKEN IF RECESSION DEEPENS. ON EXTERNAL SIDE, EDRC EXPRESSED DOUBTS REGARDING SWISS FORECASTS OF 3 PERCENT INCREASE IN EXPORT VOLUME AND FURTHER DETERIORATION OF TERMS OF TRADE, IN VIEW OF RECENT SF APPRECIATION. SWISS AGREED THAT THEIR ESTIMATES MIGHT

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HAVE TO BE REVISED TO REFLECT CHANGES IN SWISS EXCHANGE

RATE AND MORE PESSIMISTIC OUTLOOK FOR OECD AREA TRADE.
END SUMMARY.

2. OUTLOOK FOR GROWTH AND DEMAND: SWISS PROJECT REAL GNP TO FALL 1.2 PERCENT IN 1975 AFTER ZERO GROWTH IN 1974. DOMESTIC DEMAND ESTIMATED TO DECLINE BY 2.5 PERCENT, WITH MAIN STIMULUS TO DEMAND EXPECTED FROM EXTERNAL SIDE. SWISS DO NOT CONSIDER ECONOMY TO BE IN RECESSION, BUT RATHER IN PERIOD OF LEVELLING OFF, OR "NORMALIZATION" AFTER ANTI-INFLATION MEASURES OF 1973-74. SWISS FEAR THAT PREMATURE STIMULATION OF ECONOMY WOULD LEAD TO NEW SURGE OF INFLATION AT LATER DATE. THEY ALSO SEE NEED FOR STRUCTURAL ADJUSTMENT IN CONSTRUCTION INDUSTRY WHERE THERE IS SURPLUS STOCK OF HOUSING. THEY CONSIDER PERIOD OF SLACK DEMAND TO BE NECESSARY IF MANPOWER AND RESOURCES ARE TO BE SHIFTED OUT OF CONSTRUCTION SECTOR, AND THEREFORE LEVELLING OFF PROCESS SHOULD NOT GIVE WAY JUST YET TO RESTIMULATION OF ECONOMY.

3. EDRC WONDERED IF SWITZERLAND WAS NOT RUNNING RISK OF CREATING FUTURE SHORTAGE OF CAPACITY, BUT SWISS REPLIED THAT POPULATION GROWTH TREND DID NOT JUSTIFY PRESENT SIZE OF CONSTRUCTION SECTOR AND STRUCTURAL READJUSTMENT WAS NECESSARY. EDRC ALSO CONCERNED THAT SWITZERLAND WAS ABANDONING ITS COMMITMENT TO GROWTH, AND WONDERED WHY SWISS COULD NOT AIM FOR ZERO GROWTH IN 1975 RATHER THAN ACCEPTING NEGATIVE GROWTH RATE. THERE WAS POSSIBILITY IN ANY CASE THAT EXTERNAL DEMAND WOULD BE WEAKER THAN ANTICIPATED (SEE PARA 7 BELOW) WITH EVEN GREATER CONTRACTIONARY EFFECTS THAN NOW FORESEEN. THUS, THERE WOULD APPEAR TO BE SOME SCOPE FOR FURTHER RELAXATION OF MONETARY POLICY WITHOUT RISK OF SETTING OFF NEW ROUND OF INFLATION. SWISS REPLIED THAT THEY DID NOT INTEND TO FOLLOW TRULY DEFLATIONARY POLICY, AND THAT MONEY SUPPLY WAS NOW INCREASING AT ABOUT 6 PERCENT ANNUAL RATE, CONSISTENT WITH SWISS POLICY OF HOLDING GROWTH OF LIQUIDITY BELOW RATE OF INFLATION.

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4. EMPLOYMENT OUTLOOK: SWISS DEL AGREED THAT UNEMPLOYMENT IS RISING RAPIDLY, BUT ARGUED THAT GROWTH FROM ZERO BASE TO SLIGHTLY OVER 1000 UNEMPLOYED IN DECEMBER DOES NOT PROVIDE CAUSE FOR ALARM, ESPECIALLY WHEN SOME OF THIS REPRESENTS DESIRED SHAKEOUT IN CONSTRUCTION SECTOR. SWISS EXPECT LABOR FORCE TO DECREASE BY ABOUT 1 - 1.5 PERCENT IN 1975 (35,000 PERSONS), BUT REJECTED SUGGESTION THAT MUCH OF THIS MIGHT BE ABSORBED BY

FOREIGN SEGMENT OF LABOR FORCE. SWISS DO NOT CONSIDER PRESENT LEVEL OF UNEMPLOYMENT SERIOUS ENOUGH TO JUSTIFY RE-INVIGORATING ECONOMY, BUT IF PRESENT "PAUSE" DEGENERATES INTO RECESSION, THEY WILL MOVE QUICKLY TO ACTIVATE COUNTER-CYCLICAL WEAPONS (SEE PARA 6 BELOW).

5. OUTLOOK FOR INFLATION: SWISS CONSIDER PRESENT LEVEL

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OF INFLATION AT 10 PERCENT ANNUAL RATE TO BE UNACCEPTABLY HIGH, BUT THEY BELIEVE PRICE PERFORMANCE WILL IMPROVE IN 1975 DUE TO DROP IN DOMESTIC DEMAND AND LEVELLING OFF OF IMPORT PRICES. THEY FORESEE 7-8 PERCENT RISE IN CPI WITH PERHAPS 6-7 PERCENT INCREASE IN GNP DEFLATOR. IMPORT PRICES WILL BE FAVORABLY AFFECTED BY APPRECIATION OF SWISS FRANC, BUT OUTLOOK ON DOMESTIC SIDE NOT SO FAVORABLE WITH PRICE RISES EXPECTED FOR PUBLIC SERVICES AND AGRICULTURAL PRODUCTS. HOWEVER, SWISS EXPECT DECELERATION IN DOMESTIC PRICES TO CONTINUE, PROVIDED THEY DO NOT EASE UP ON DEMAND RESTRAINT TOO SOON.

ON WAGE FRONT, SWISS ARE OPTIMISTIC THAT NOMINAL SALARIES WILL BE CLOSELY RELATED TO EXPECTED INCREASES IN CONSUMER PRICES. THEY SEE NO CATCH-UP EFFECT SINCE 1974 WAGES INCREASED AT FASTER RATE THAN PRICES, AND SLOWDOWN IN ECONOMY WILL REDUCE BARGAINING POWER IN WAGE NEGOTIATIONS.

6. POLICY ORIENTATION: DESPITE SWISS CONVICTION THAT TIME IS NOT YET RIPE TO RE-STIMULATE ECONOMY, THEY ARE LIMITED OFFICIAL USE

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AWARE THAT SUCH ACTION MAY SOON BE NECESSARY AND HAVE PREPARED COUNTER-CYCLICAL PROGRAMS TO DEAL WITH IT. THESE INCLUDE AN ALTERNATIVE FEDERAL BUDGET, WHICH CAN BE ACTIVATED BY EMERGENCY DECREE, AND A CONTINGENCY RESERVE FOR CONJUNCTURAL PURPOSES. SWISS DELS WERE ALSO CAREFUL TO POINT OUT THAT DESPITE REJECTION OF TAX PROPOSALS IN DECEMBER REFERENDUM, TOTAL GOVERNMENT EXPENDITURE (INCLUDING CANTONS) WILL STILL BE SLIGHTLY EXPANSIONARY AND HELP TO OFFSET SLOWDOWN IN PRIVATE SECTOR ACTIVITY. EDRC WONDERED WHAT DEVELOPMENTS WOULD CONSTITUTE TRIGGER FOR ACTIVATION OF ALTERNATIVE BUDGET, TO WHICH SWISS REPLIED THAT THEY WOULD HAVE TO AWAIT RESULTS OF CHANGES IN NEW REGULAR BUDGET NOW BEING CONSIDERED BY PARLIAMENT, BEFORE PROCEEDING TO ALTERNATIVE BUDGET.

7. BALANCE OF PAYMENTS: SWISS DEL ANTICIPATED THAT EXPORT VOLUME WOULD GROW BY 2-3 PERCENT IN 1975, BASED ON OECD ESTIMATES FOR GROWTH OF OECD AREA TRADE OF ABOUT 4 PERCENT. HOWEVER, US DEL POINTED OUT THAT SECRETARIAT HAD REDUCED ITS OECD AREA TRADE FIGURES TO UNDER 1 PERCENT GROWTH, AND SWISS AGREED THAT CURRENT EXPORT GROWTH ESTIMATE MIGHT HAVE TO BE MODIFIED. OTHER DELS NOTED THAT WEAKER EXPORT GROWTH WOULD REMOVE EXPECTED STIMULUS TO TOTAL DEMAND.

8. TERMS OF TRADE: SWISS SAW CONTINUED DETERIORATION OF TERMS OF TRADE WITH EXPORT PRICES RISING 6 PERCENT AND IMPORT PRICES 9 PERCENT IN 1975. EDRC CHAIRMAN (HUET) QUESTIONED ASSUMPTION OF CONTINUED TERMS OF TRADE DETERIORATION, NOTING THAT SWISS EXPECTED SAME TERMS OF TRADE AS IN 1974 DESPITE FACT THAT IMPORT PRICES WERE FALLING WORLDWIDE AND SWISS FRANC HAD APPRECIATED CONSIDERABLY. SWISS NOTED THAT THEIR FORECASTS WERE MADE PRIOR TO CHANGE IN SF PARITY.

9. CAPITAL INFLOWS AND EXCHANGE RATE: DESPITE QUESTIONS BY EDRC SWISS WERE UNABLE (OR UNWILLING) TO COMMENT ON POSSIBLE FUTURE CAPITAL CONTROL MEASURES OR ON

DESIRABLE LEVEL FOR SF-DOLLAR PARITY. THEY MADE CLEAR
THEIR CONCERN REGARDING APPRECIATION OF SWISS FRANC,
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WHOSE TRADE-WEIGHTED VALUATION HAD INCREASED 45 PERCENT
SINCE NOVEMBER 1971. SWISS PLAINLY FEARED THAT RAPID
SF APPRECIATION WILL REDUCE EXPORT COMPETITIVENESS AND
FORCE EXPORT INDUSTRIES TO CUT PROFIT MARGINS, BUT THEY
DID NOT EXPLAIN WHAT MEASURES THEY MIGHT ADOPT TO
ALLEVIATE SUCH TENDENCIES. SWISS ALSO RESTATED THEIR
DESIRE TO AVOID LARGE CAPITAL INFLOWS. SECRETARIAT
SUGGESTED THAT RELAXATION OF MONETARY POLICY WOULD
SERVE TO REDUCE DOMESTIC INTEREST RATES AND REMOVE
INCENTIVE FOR INFLOWS, THEREBY AVOIDING NECESSITY
OF CAPITAL CONTROLS.
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